

property is a mixed-use commercial building consisting of retail space, office space, 372 hotel rooms with a rooftop swimming pool, ballroom and meeting rooms. There are 443,417 square feet of rentable space. However, about 50,000 square feet are used for storage. There are 28,615 square feet of commercial space. The property is zoned UR (Urban Renewal), and the land is subject to the Urban Renewal Plan.

3. The District's proposed assessment for tax year 1985 was originally \$83,747,000. The total assessed value for 1982 was \$42,000,060; for 1983, \$46,586,570; for 1984, \$43,082,220. The assessed value for 1982, 1983, and 1984 were determined by reductions made by the Board of Equalization and Review following appeals.

4. Robert Klugle is the Chief of the Standards and Review Division of the Department of Finance and Revenue. In 1985, his Division reviewed all office buildings throughout the city. They did 600-700 properties within a two-month period. Mr. Klugle felt that market activity was plentiful and that market values were going up. He believed that their assessments were low. Using a mass appraisal technique, they undertook the assessments for the 600-700 properties. Mr. Klugle purports to have assessed this property at 100% of market value. However, he did note that he had reduced other buildings to 90% of market value.

5. Mr. Klugle refused to take into account in estimating the income for the property a vacancy and occupancy loss reported by the taxpayer on the 1982 income and expense

form required to be submitted to the government. In 1983, the vacancy and credit loss reported by petitioner was \$3,645,250. In a statement signed by Mr. Klugle and filed with the Board of Equalization and Review, he stated that the latter figure was already reflected. Therefore, he concluded it should not be deducted. During the course of this trial, Mr. Klugle testified that the vacancy loss had already been considered by the Department in reaching its conclusions. He provided a formula by which the vacancy loss was taken into account. By ascertaining the total number of room nights available for the year and multiplying that number by the average room rate per night, the revenue for full occupancy could be determined. If there were a 70% occupancy rate, you would ascertain 70% of that number to determine the number of room nights available at 100%. Had the Department actually used the formula, the hotel's vacancy loss would have been taken into account. However, it appears the Department did not. Petitioners' exhibit 3A is the work sheet prepared by Mr. Klugle for the hotel portion of the property. A review of the work sheet reflects that Mr. Klugle divided the number of rooms into the total annual room income as reported by the taxpayer for 1982. The result was divided by the number of days per year to determine the average income per room. That result, \$10,816,629, represents the amount of income that the owner would have received had all rooms been occupied. It does not reflect the actual income received by the owner. The occupancy rate was not applied to that figure. Therefore, it appears

that the vacancy rate for the hotel has not been accounted for in Mr. Klugle's calculations as they appear on petitioners' exhibit 3A. Thus, the actual income for the hotel is overstated by a figure in excess of \$3 million. If a vacancy loss of \$3 million had been allowed, the difference in the value for the hotel portion, as determined by Mr. Klugle, would have been about \$22,050,519 less than he determined. Using the cap rate developed by Mr. Klugle, the hotel portion of the building would have had an indicated value of \$7,935,980.

6. A part of the problem may be traced to the form and the instructions provided to taxpayers by the government. The form indicates that the total annual income if 100% occupied should be inserted on page 2. In 1982, petitioners inserted \$15,895,744 to reflect that total figure. The total figure represented room income of \$10,816,629; store income, \$62,746; and other department incomes, \$5,016,369. Petitioners reported the gross hotel room income at \$10,816,929. This figure represented the gross income for the hotel, if all rooms were occupied. The figure was not the actual income received for hotel rooms by the taxpayer. By subtracting the vacancy and credit loss from the annual room income, the amount of income which the tax payer actually received results. Mr. Klugle acknowledged some confusion with the forms, and he indicated that the form was changed subsequently.

7. Mr. Klugle used a capitalization rate of .1463 for the hotel. He derived this cap rate by using 12.5% for all

hotels and adding the 2.03% for the tax factor. The selection of 12.5% for all hotels in the city.

8. Both sides offered expert testimony at trial. Donald Urquhart appeared for petitioners and Ryland Mitchell, III, appeared for respondent. Both witnesses are expert real estate appraisers and consultants. The qualifications of Mr. Urquhart are contained in petitioners' exhibit no. 16 and they are incorporated herein by reference. The qualifications for Mr. Mitchell are set forth in respondent's exhibit no. 1, and they are incorporated herein by reference. Both witnesses, who were accepted as experts by the Court, are well qualified in their fields.

9. The subject real property was valued by Mr. Klugle, the District's employee, at \$83,747,000. The Board of Equalization and Review reduced the figure to \$65,150,600. In Mr. Urquhart's opinion, the market value of the subject property as of January 1, 1984 is \$44,500,000. Mr. Mitchell concluded that the property on that same date was valued at \$79,000,000.

10. Mr. Urquhart considered and rejected the cost approach to value for this property. The witness felt that the cost approach to value would be meaningless for the subject property because of its age, physical depreciation, and functional and economic obsolescence. The witness relied primarily upon the income approach to value. He also developed a comparable sales approach as supporting documentation for the

results achieved by the income approach to value. Thus, he considered all three recognized approaches.

11. Mr. Mitchell did not use the cost approach to value either. In his view, such an analysis was not pertinent to a property with an established income record. Additionally, he stated that estimates of depreciation which were necessary for consideration, would not be precise. This expert used an income approach to value in estimating the value of the hotel and office portions of the building and in estimating the total value for the subject. Although the witness gave primary consideration to the income approach in determining value for this property, he relied on market data of recent sales for office buildings and hotels to support his conclusions.

12. The determination of the income and expense figures used by the witnesses in reaching a valuation by the income approach reflects few major differences. A major area of disagreement between the experts is accounted for in the calculation of hotel income. Mr. Mitchell candidly admitted that he did not understand the credit loss reflected on the income and expense forms submitted by the property owner. The property owner had indicated for 1982 a vacancy and credit loss in the total amount of \$3,125,407; and in 1983, \$3,645,250. Mr. Mitchell rejected the figures. He was not aware that the owner had included in the reported figures of income from hotel rooms the amount it would have received if the hotel had been 100% occupied. Mr. Mitchell used an effective gross of \$12 million for the hotel. This figure was determined by

projecting an average daily room rate of \$115 and an occupancy rate of approximately 76.5%. The result is \$11,945,245. Thus, Mr. Mitchell appears to have taken into account the vacancy loss figure. However, the average daily room rate selected by Mr. Mitchell contrasts with the owner's experience for the three years preceding the valuation date. The average daily room rate was \$79.66 for 1982; \$88.11 for 1983; and \$87.63 for 1984. Mr. Klugle used the \$79.66 figure. Mr. Urquhart suggested an average rate of \$88, which is closer to actual experience. This average room rate takes into account group rates, discounts for commercial organizations, government rates and the like. The schedule of room rates is different than the rate actually charged because of these various discounts. Selecting a higher room rate, Mr. Mitchell attempted to reflect what he believed to be the hotel's superior-to-middle market, but a notch below a luxury facility. However, a survey conducted by Mr. Urquhart showed that southwest rates for hotels are slightly lower than others. While a survey conducted by Mr. Klugle showed growth in income for hotels, it did not show growth at a rate supportive of the \$115 average price used by Mr. Mitchell. Contrary to being the most attractive hotel for tourists, the location and services makes the hotel more attractive to the corporate and governmental market for which discounts are common. Under these circumstances, the amount attributable as hotel income by Mr. Mitchell does not appear to be supported by the actual experience of the property nor by the market data. Therefore,

the figure suggested by Mr. Mitchell as income to the hotel cannot be accepted.

13. Although this is a mixed-use property, a prospective purchaser must view the entire entity. Therefore, in determining the vacancy and credit loss, Mr. Urquhart considered the entire property. He found that the vacancy and credit loss for the whole property in 1982 was 13.5%; for 1983, 14.5%; and for the 1984 stabilized year, 11.25%. Although the retail and office portions of the building were 100% occupied at the time the figures were gathered, Mr. Urquhart concluded that for long-term ownership a vacancy and credit loss of 5% should be considered for the office and retail portion the building. Mr. Mitchell also allows a 5% vacancy and credit loss for the office portion only. Mr. Urquhart suggests a conservative vacancy and credit loss including the hotel of \$2,867,951. He applied the 11.25% selected for a stabilized year to the total potential gross income to ascertain the vacancy and credit loss including the hotel. This takes into consideration the actual losses reported by the hotel in the past. Consideration must be given to the vacancy losses, particularly since the income reported is as if the property were 100% occupied. Mr. Urquhart's calculation does that. It should be accepted. The vacancy and credit loss proposed by Mr. Urquhart is slightly above the actual vacancy and credit loss reported in the amount of \$2,330,172. However, considering the prior years when these losses were reported in 1982 as \$3,124,407 and in 1983 as \$3,645,250, the selection of

the \$2,867,961 or 11.25% seems realistic in an effort to achieve a stabilized amount.

14. For 1982, 1983, and 1984, the gross income for this property did not increase significantly. Mr. Urquhart projected a potential gross income of \$25,492,893. Mr. Mitchell projected a total gross income for the subject of \$26 million. These figures are so close that a line-by-line analysis of the minor differences in the calculations of the two appraisers would not be necessary or useful. Some of the differences are accounted for in that Mr. Mitchell uses rounded figures. As indicated in the preceding paragraphs, Mr. Mitchell allowed only a vacancy and collection loss of 5% or \$400,000 for only the office portion of the property. He did so because he had taken into account the vacancy loss of the hotel in his calculation of the hotel's income. However, he overstated the hotel's income by using a room rate of \$115 per night instead of the stabilized average room rate of \$88 per night. Had he used \$88, he would have reached the following income for the hotel if fully occupied:

$$\$99 \times 372 \text{ (rooms)} \times 365 \text{ days} = \$11,948,640$$

If he had applied the vacancy rate he indicated (76.5%) to this number, he would have obtained an income for the hotel of \$9,140,709. Therefore, the hotel's actual income is overstated by \$2,859,291. Mr. Mitchell's income and expense projection formula was adequate, but the figures used produced an inaccurate result. Mr. Mitchell's estimated net income before taxes would have been \$6,679,709 if he had used the figures

stated above. This number is almost the same as the net operating income reached by Mr. Urquhart of \$6,222,347.

While Mr. Mitchell's formula for considering vacancy loss is acceptable, Mr. Urquhart's is also acceptable. He reflects the total income for the hotel if fully occupied and reduces total potential gross income by the vacancy and credit loss for the entire property, including the hotel. That adjustment of \$2,867,951 is supported by the evidence and should be allowed. The adjusted net operating income of \$6,222,347 indicated by Mr. Urquhart is supported by the evidence and should be accepted for use in the income approach to value.

15. The second major area of difference accounting for the wide variation in estimated fair market value suggested by the experts is in the area of the capitalization rates to be applied to income to determine a value for the property. Mr. Klugle used .1463. The Board of Equalization and Review used .1473. Mr. Mitchell developed different capitalization rates for the hotel and the office portions of the building. However, in his final calculations, he used a 12% figure. He thought that the overall capitalization should be 10%. There had to be added to that figure the tax burden of 2, thereby developing a total capitalization rate (adjusted for exclusion of real estate taxes) of 12%. Mr. Urquhart used a capitalization rate of 14%.

16. Capitalization of income is the method of converting a single year's estimate of income into an indicated

value by the income capitalization approach. A capitalization rate is determined by considering various factors relating to the property, including its location, physical characteristics, inflation, risk, economic life, recoverable expenses, and the like. It is also determined by reference to the market and the availability of other investment opportunities. Various formulas and techniques have been developed for determining the appropriate capitalization rates. The rate is critical to the determination of value.

17. In determining a capitalization rate, Mr. Urquhart examined economic and financial indicators. It was his opinion that corporate bonds provide a good indication of risk ratings for real estate, although real estate investments are more risky and less liquid. The market rates and bond yields during the pertinent period were shown by Moody's Bond Survey to be:

	<u>Nov.</u> <u>1983</u>	<u>May</u> <u>1983</u>	<u>Nov.</u> <u>1982</u>	<u>Nov.</u> <u>1981</u>
Corporate Bonds (Aaa)+	12.25	11.46	11.68	14.22
Corporate Bonds (A)+	12.97	12.68	13.81	15.82

Financial indicators at the end of 1983 reflected average interest rates for loans on office buildings under certain terms to be 12.22%. Relying on such data, it was Mr. Urquhart's opinion that the appropriate yield rates for S.W. office buildings as of January 1, 1984 (the valuation date for tax year 1985) would range between .13 and .15. For hotels, the range was .15 to .17. He also developed a capitalization rate based on the traditional band of investment technique. By

this method, a weight average rate is calculated by applying the projected mortgage constant times the loan to value ratio plus the remaining equity portion times the estimated equity dividend or yield rate. With this formula, Mr. Urquhart developed a range of capitalization rates from .114834 to .124049. From this data, the petitioners' expert concluded that an overall capitalization factor of .1206 was indicated. The factor of .203 had to be added to this rate to take into account the real estate tax factor, which is not included in the development of net operating income. This resulted in a rate of .1409 which was rounded to 14%. The capitalization rate developed by Mr. Urquhart considered specific qualities of the property, the income characteristics, and other factors affecting buyer motivation. The factor is similar to the overall factor utilized by both Mr. Klugle and the Board of Equalization and Review. The rate appears to be supported by the evidence and sound reasoning.

18. Mr. Mitchell developed separate capitalization rates for the office portion and for the hotel portion of the building. He stated that the capitalization rate selected for the office portion only was supported by market data. Mr. Mitchell found support for the selection of an 8% capitalization rate from sales of four offices. Since there is no sales information for truly comparable properties, the 8% figure must be regarded with caution. Whether it reflects what happens with a property like the subject is uncertain. Mr. Mitchell found insufficient information to derive overall

capitalization rates for hotels. Since he considered a hotel to be a riskier investment, he determined that a higher rate was appropriate. Therefore, he selected a 12.5% overall capitalization rate for application to the hotel portion of the property. Although this witness developed separate capitalization rates, a willing buyer normally considers the entire property and applies one rate to the entire income stream. The buyer purchases a single property with all of its risks. The value of two rates is questionable under the circumstances.

19. Mr. Mitchell stated that he also gave consideration to yields in the market which offer alternate investment opportunities. He believed that BAA bond yields related more to real estate due to its slightly higher risk. The witness could not or did not show how these previously higher yield investments translated into his selection of a 10% unadjusted overall rate of return.

20. Mr. Mitchell also undertook an internal rate of return analysis to determine capitalization rate. This technique is being used by some qualified investors. In this approach, the estimated yield that the market will require to be attractive to the subject property on the basis of a projected five-year net income stream and value of the property at the end of that period is considered. One problem with the analysis is the assumptions that must be made by the person performing the calculation. The witness had to make certain assumptions about the property, its income, its expenses, and

the investors and their circumstances. The variability of these factors render the results somewhat speculative. The witness had to assume a sales price at the end of the investment and percentage increases in the total income stream over the period of his projections. The bottom line in this analysis is only as good as the assumptions or "speculations" made. There are too many assumptions for which no justification is available.

21. The capitalization rate advanced by Mr. Urquhart is supported by the evidence. Applying Mr. Urquhart's capitalization rate to the stabilized income results in the following calculation of indication of value:

$$\text{Value} = \frac{\text{net income}}{\text{capitalization rate}} \quad \text{or} \quad \frac{\$6,222,347}{.14} = \$44,445,335$$

This figure should be rounded to \$44,500,000 as suggested by the expert. He assigns \$23,000,000 to the land value.

22. The overall suggestion of value given by Mr. Mitchell at \$79,500,000 produces a negative cash flow of approximately \$1.7 million if the property were purchased for the value he reached. An investor would not be interested in such an investment. Accordingly, the estimate of value made by Mr. Mitchell is rejected.

Conclusions of Law

In appealing from an assessment, petitioners are entitled to a trial de novo. D.C. Code § 47-3303 (1981); District of Columbia v. Washington Sheraton Corporation, 499

A.2d 109, 111 (D.C. 1985), citing Rock Creek Plaza-Woodner, 466 A.2d 857, 859 n.1 (D.C. 1983). Petitioners have the burden of proving the incorrectness of the assessment. Brisker v. District of Columbia, 510 A.2d 1037, 1039 (D.C. 1986); See Wyner v. District of Columbia, 411 A.2d 59, 60 (D.C. 1980). They are not required to establish the correct value of their property. Id.

Petitioners have met their burden of proving the incorrectness of the assessment. Sufficient evidence appears of record from which the Court can determine the fair market value of this property. When a taxpayer appeals to this Court, the Court can affirm, cancel, reduce or increase the assessment. D.C. Code § 47-3303 (1981); See Rock Creek Plaza-Woodner, Ltd. v. District of Columbia, 466 A.2d at 859 n.1.

In assessing this property for the tax year in question, the District almost doubled the assessed value in a single year. No support is shown for such a radical departure from the prior year's assessment. The property's income had no radical changes in its history nor any indication that such changes would occur. The District failed to take into account the hotel's actual income. This resulted in a substantial increase in value determined by the District. At trial, the District did not support its own original estimate of value of \$83,747,000. Rather, it relied on a lower figure. All of these circumstances demonstrate the inaccuracy of the assessment.

The Court was presented with a wide disparity between the opinions of value of the two expert witnesses. One valued the property at \$44,500,000. The other determined an estimated value of \$79,000,000 for the property. Both experts are well qualified in their fields. Therefore, in resolving the conflict in their testimony, the Court must weigh the logic of the reasons given in support of the opinions and the evidence in the case which favors or opposes their respective positions. For the reasons stated in the foregoing findings, the Court has rejected the capitalization rate proposed by Mr. Mitchell and accepted the capitalization rate proposed by Mr. Urquhart. After weighing the evidence, the Court has ascertained the reasons for the difference in the net operating income indicated by each witness. The reasons for the difference was the failure of Mr. Mitchell to take into account the indicated room rate for the property and to develop the actual loss to the property for vacancies based on accurate figures. Having made these adjustments, the Court finds that the evidence supports a value of \$44,500,000 as proposed by Mr. Urquhart. This figure adequately represents the value of the property as of the valuation date, January 1, 1984 for the reasons stated in the foregoing findings.

There are three generally recognized approaches to value: comparable sales approach, the replacement cost approach and the income approach. Safeway Stores, Inc. v. District of Columbia, 525 A.2d 207, 209 (D.C. 1987). Both witnesses considered all three approaches to value as required.

The income approach was most heavily relied on by each of them. The reasons for the great difference in their opinions arose from an improper calculation of net operating income made by respondent's witnesses and application of an capitalization rate not supported by a preponderance of the evidence.

In assessing real property, the value of the land and improvements must be identified separately. D.C. Code § 47-821 (a). The land value has been retained by the District at \$22,396,367 for 1986 and 1987. This figure was proposed for 1985 as well. The petitioners' expert proposes \$23,000,000. The later figure is reasonably close to respondent's estimate, and it is supported by the expert witness. Therefore, it should be used.

For the foregoing reasons, it is by the Court this 10th day of July, 1990,

ORDERED that the assessed value for the property for tax year 1985 is determined to be as follows:

<u>Land:</u>	\$23,000,000
<u>Improvements:</u>	\$21,500,000
<u>Total Assessment:</u>	\$44,500,000

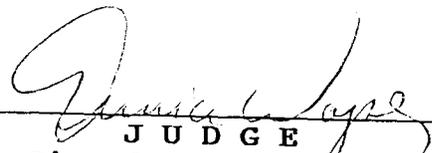
and it is

FURTHER ORDERED that the petitioners are entitled to a refund for any over payment of taxes as a result of an assessment greater than indicated by the fair market value as stated in the foregoing paragraph, and it is

FURTHER ORDERED that the assessment records shall be adjusted to reflect an assessed value consistent with this order, and it is

FURTHER ORDERED that petitioners shall submit a proposed order providing for a refund of the overpayment, and it is

FURTHER ORDERED that the parties shall appear before the Court on July 19, 1990 at 9:30 a.m. to present the order and/or for status hearing, unless prior to that date, the required order has been submitted to the Court.


J U D G E
Signed In Chambers

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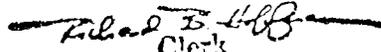
Harold L. Thomas, Director
Department of Finance and Revenue


7/11/90

District of Columbia
Court of Appeals

DISTRICT OF COLUMBIA
COURT OF APPEALS

FILED JUL 30 1990

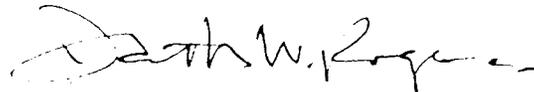

Clerk

O R D E R

WHEREAS, the Chief Judge of the Superior Court has presented a certificate of necessity pursuant to D.C. Code § 11-908 (b) (1981) indicating a necessity exists requiring the designation and temporary assignment of the Honorable Annice M. Wagner, Associate Judge of this Court, to serve on the Superior Court;

NOW, THEREFORE, I, Judith W. Rogers, Chief Judge of the District of Columbia Court of Appeals, pursuant to the provisions of D.C. Code § 11-707 (b) (1981), do hereby designate and assign the Honorable Annice M. Wagner, Associate Judge of the District of Columbia Court of Appeals, to serve temporarily as a judge of the Superior Court of the District of Columbia for the purpose of entry of judgments and orders on or before July 31, 1990, in the following pending proceedings, Tax Docket Nos. 3754-86 and 3933-87, *Trilon Plaza Co. et al. v. District of Columbia*, and Tax Docket No. 3872-87, *William B. Wolf, Sr. v. District of Columbia*.

BY THE COURT:

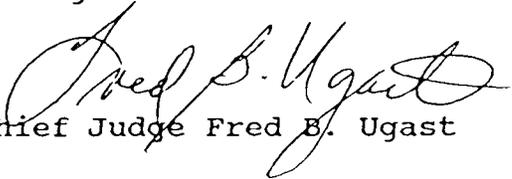


JUDITH W. ROGERS
Chief Judge

SUPERIOR COURT OF THE DISTRICT OF COLUMBIA

CERTIFICATE OF NECESSITY

It appearing that the business of the Court makes it necessary for the efficient administration of justice that the Honorable Annice M. Wagner enter orders and judgments on or before July 31, 1990, in the following pending proceedings in this Court, Tax Docket Nos. 3754-86 and 3933-87, *Trilon Plaza Co. et al. v. District of Columbia*, and Tax Docket No. 3872-87, *William B. Wolf, Sr. v. District of Columbia*, it is this 30th day of July, 1990, certified pursuant to D.C. Code § 11-908 (b) (1981), that there is a need for the temporary assignment of the Honorable Annice M. Wagner, Associate Judge of the District of Columbia Court of Appeals to serve as a judge of the Superior Court of the District of Columbia for the administration of justice in the above-mentioned actions.


Chief Judge Fred B. Ugast